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THE TEXAS LIMITED PARTNERSHIP AS A VEHICLE FOR REAL ESTATE INVESTMENT

ROBERT LEON SONFIELD, JR.*

A recent article in the *Michigan Business Review* published by the Graduate School of Business Administration at the University of Michigan contained an in-depth analysis of real estate investment. The author, Karl G. Pearson, observed:

> An investment in good real estate, well located, provides the best possible hedge against inflation. For the last twenty-five years, such real estate has shown remarkable increases in value, and its dynamic rise has outdistanced the inflationary spiral. . . . [R]eal estate in general produces more percentage points of income than do other investments. It enjoys a margin over after-tax yields on stocks. It provides a return for some concerns, like railroads with real estate investments, higher than from their principal operation.[1]

Professor Pearson concludes that there is a place in real estate investments for the small investor through group participation such as joint ventures, syndications and limited partnerships. Therefore, the subject of our discussion is an analysis of the syndication and the selection of the appropriate legal form.

WHAT IS REAL ESTATE SYNDICATION?

A real estate syndication may be generally defined as an association of a number of investors combining their resources for the purpose of acquiring a large property that any one of the several investors is unable or unwilling to undertake individually.[2] Generally, a real estate syndication may be classified in two separate categories: (1) a syndication that owns and operates one single property without the purpose or intention of acquiring any further or additional properties; and (2) the syndication that is formed for the purpose of acquiring a multitude of properties within certain predetermined guidelines as to geographic location and/or the type of property to be acquired.

The syndication enjoys the benefit of professional management which should result in sound investment judgment, instinctive know-

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1 K.G. Pearson, *The Real Estate Investment Boom*, 21 MICH. BUS. REV., (1969).

2 BLACK'S LAW DICTIONARY, 1620 (4th ed. 1957); WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (1963).

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how and professional counsel, the expense of which can only be justified by a large investment portfolio. This management should include the ability to supervise both income producing property and unimproved property, and should include the ability to properly structure the acquisition from the business standpoint.

SELECTION OF THE LEGAL FORM

A prerequisite to a proper determination of the most advantageous legal form is a determination of the desired results of such a choice. In order to derive the maximum individual benefit to each investor, it is essential that the syndicate be structured in such a manner that a portion of the purchase price of the property be borrowed funds. On the other hand, the form selected should protect each investor from any individual or personal responsibility in connection with the borrowed funds. Thus, if the syndicate purchases property for $1,000,000 and borrows $900,000 of the purchase price and the property increases in value by an amount equal to twenty per cent of the orginal price ($1,200,000), the sale results in a cash return to the investors of $300,000 or a gain of two-hundred per cent on the original investment. This concept of leverage by creating a return on the equity investment has a very undesirable side effect. If the value of the property declines or there is a down turn in the economy, the individual investors may be personally responsible both jointly and severally for the payment of the entire $900,000. Therefore, the selection of the appropriate legal form for real estate syndication must necessarily be directed to a method of limiting the individual liability of each investor to the amount of his actual cash investment and not expose him to the potential of being required to pay a large indebtedness which is above and beyond his capacity to liquidate.

One of the principal advantages of real estate investment is the tax shelter created by the deduction of mortgage loan interest and real property taxes, as well as depreciation from other income, such as salary. There are further tax benefits to be derived. For instance, if the property is sold on a deferred payment plan the capital gain profit can be spread over a period of years. This alleviates the tax impact in the year of the sale. The selection of the legal form for the real estate syndicate must be predicated upon the desire to cause such tax benefits to pass directly to the individual investor without first being taxed to the syndicate as a legal entity. This requirement is particularly

essential in the case of income producing properties which can create a tax-free cash flow if the depreciation permissible for tax purposes exceeds amortization of the principal of the debt.

As a final consideration in selecting the proper legal form, attention must be directed to minimizing the reporting requirements of the syndicate itself to federal and state regulatory agencies. Different types of legal entities are burdened with diverse reporting requirements which can be expensive to the syndicate as well as time consuming for the investors who do not have access to independent facilities for assembling the necessary information and preparing the necessary forms.

In summation, the ideal legal form for the syndicate will: (1) have the authority to borrow money for a portion of the purchase price of the property acquired; (2) create no liability upon the individual members of the syndicate for repayment of the money borrowed; (3) pass the taxable income (or loss) directly to the individual investor without being first taxed at the syndicate entity level; (4) require a minimum of reporting to federal, state or other regulatory agencies. With these criteria in mind, we shall examine various available legal forms and analyze their respective attributes with respect to our desired goal.

Corporation

A corporation can utilize financial leverage and limit the liability of the individual investor all within our basic guidelines. However, the Texas franchise tax provides for a basic tax of $2.75 per $1,000 of the sum of the stated capital, surplus and undivided profits.[3] This article further provides for an additional tax on an indebtedness bearing a maturity date of one year or more from date of issue for the taxable period from May 1, 1970 to and including April 30, 1971, in the amount of $1.50 per $1,000 or a fractional part thereof applied to that portion of taxable debt allocable to Texas. This additional franchise tax decreases at the rate of $.50 per/$1,000 per year until April 30, 1973, at which time such additional tax expires. Furthermore, there is a tax of $2.75 per $1,000 or fractional part thereof applied to the assessed value for county ad valorem tax purposes. An additional tax in the fixed amount of $35 is also levied.

Thus, a corporation with a capital of $100,000 which purchases property for $1,000,000, and utilizes $900,000 of borrowed funds pay-

[3] TEX. TAX.—GEN. ANN. art. 12.02 (1969).

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able over a long term, must pay a franchise tax of $275 on its stated capital, and $1,300 on its long term indebtedness. Further, assuming an assessment evaluation for city ad valorem tax purposes of twenty per cent of value, or $200,000, the corporation will have to pay $550 for that portion of the franchise tax allocable to its property, as well as a fixed tax of $35, or a total of $2,160 in an annual franchise tax, all as a result of selecting the corporate form. Likewise, the corporation is required to file a state franchise tax return as well as a corporate income tax return. If there are employees, a withholding tax return and a state unemployment tax return must also be filed.

However, a corporation can elect to be taxed as a partnership by filing what is commonly designated as a Sub-Chapter S election in accordance with the Internal Revenue Code of 1954.[4] This election is not available if the corporation has more than ten shareholders and if more than ten per cent of the corporate revenue is from rents or royalties. There is also some question if the individual shareholder of a Sub-Chapter S corporation may apply the operating loss of the corporation against the shareholder's other income.

General Partnership

A general partnership enjoys the direct taxation of the partner and is not required to file a franchise return. However, all partners are jointly and severally liable for any partnership obligations created by a single partner. Therefore, the limited liability of the investing partners is not available against the indebtedness utilized to create financial leverage.

Joint Venture

A joint venture is merely a general partnership organized for a specific purpose. Thus, the same rules with respect to liability, tax treatment and payment apply to a joint venture as to a general partnership.

Simple Trust

A trust created under the Texas Trust Act[5] may be organized for the purpose of holding the bare legal title to real estate with the beneficial ownership vested in the investors. The interest of the beneficiary, as a matter of law, is an undivided ownership of the real property constituting the corpus of the trust. This can present substantial problems in the event of the death of a beneficiary.

[4] 26 U.S.C.A. §§ 1371-77 (1967).
[5] TEX. REV. CIV. STAT. ANN. art. 7425b-1 (1960).

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Section 2 of the Texas Trust Act indicates that the act does not apply to real estate syndication.[6] One of the principal purposes of a real estate syndication is to utilize the benefit of experienced professional management, and it necessarily follows that the trustee, as the syndicate manager, must assume certain trust duties. We must then conclude that a trust created for the purpose of holding title to real estate for the benefit of a group of investors must be subject to the provisions of the Texas Trust Act, with the attendant statutory requirements relating to the powers, duties, and responsibilities of trustee in the management of trust properties.

Real Estate Investment Trust

The Internal Revenue Code of 1954[7] provides special tax treatment for unincorporated associations principally deriving their income from real property or real estate mortgages. However, there are a number of complex requirements that must be satisfied in order that the benefits of such preferential tax treatment may be realized. The nature and scope of the real estate investment trust is of such complexity that its application to real estate investments can reasonably justify exclusive treatment in an article at least as voluminous as this one. Therefore, we shall only comment that the regulatory requirements to qualify are so burdensome and so complex that compliance cannot be justified for any purpose other than a real estate venture of the magnitude of several million dollars.[8]

Limited Partnership

The limited partnership is the only legal form which provides the utilization of debt equity leverage without resulting in either liability upon the limited partners or a tax imposed upon the debt. The partnership's gain (or loss) can pass directly to the limited partners without being taxed at any intervening level. The partnership is required to file only an information income tax return and not a franchise tax return or any extraordinary reports whatsoever. Therefore, based upon experience and the reasons set out in this section, it is the author's firm opinion that a limited partnership is the most advantageous legal form for the purpose of real estate syndication. This recommendation is subject to satisfying the criteria for preferential tax treatment.

[6] TEX. REV. CIV. STAT. ANN. art. 7425b-2(4) (1960), "instruments wherein one or more persons are mere nominees for one or more persons without any disclosed beneficiaries and without any active trust duties."

[7] 26 U.S.C.A. §§ 856-58 (1967).

[8] F. Pinedo, *Real Estate Trust in Texas*, 24 TEX. BAR. J. 823 (1961).

TAX TREATMENT OF A LIMITED PARTNERSHIP

The Internal Revenue Code contains specific rules for the taxation of partners.[9] A draftsman of partnership instruments must be acutely aware of the effects of such rules in order to properly approach the preparation of the necessary agreements.

A limited partnership is required to file a partnership income tax return (Form 1065) which contains each partner's distributive share of the partnership income or loss to be reported in his individual income tax return. The Internal Revenue Code permits flexibility in the terms of the partnership agreement so that the amount of the distributive share of each partner and his tax liability resulting therefrom can be controlled to a considerable extent by the terms of the partnership agreement. In the absence of an express agreement, each partner will be given a proportionate share of the income (or loss) for tax purposes in accordance with his distributive share of the partnership.[10] However, the partners may specifically provide for each individual's share of such items as capital gains and depreciation, depletion of contributed property, liquidation of a retired partner's interest, charitable contributions, and foreign taxes.

> The term "partnership" is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. Thus, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954.[11]

The limited partnership must have the actual characteristics of a partnership to receive the preferential tax treatment.

> An organization which qualifies as a limited partnership under State law may be classified for purposes of the Internal Revenue Code as an ordinary partnership or as an association. Such a limited partnership will be treated as an association if, applying the principles set forth in § 301.7701-2 the organization more nearly resembles a corporation than an ordinary partnership or other business entity.[12]

In determining whether an organization resembles a corporation

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9 26 U.S.C.A. §§ 701-08 (1967).
10 26 U.S.C.A. § 704b (1967).
11 Int. Rev. Reg. 301.7701-3 (1969).
12 Int. Rev. Reg. 301.7701-3(b) (1969).

or an ordinary partnership, it is necessary to examine the four basic corporate characteristics, and, if two or more of such corporate characteristics do not exist the organization will not be taxed and the income (or loss) will be passed directly to the partners. Therefore, we will examine each of the corporate characteristics in order that the draftsman of the limited partnership agreement creating the real estate syndicate may be certain that at least two of such characteristics do not exist.

Continuity of Life

> The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners.
>
> (a) Under a right so stated in the certificate, or
> (b) With the consent of all members.[13]

For federal income tax purposes, this provision is not considered such continuity of life to support taxation as a corportion. Furthermore, a limited partnership organized under the Uniform Limited Partnership Act is specifically considered by the Service to lack continuity of life. Therefore, a limited partnership can provide for continuation on the death of a general partner by agreement of the remaining general partners and still avoid the construction of continuity of life for tax purposes. In connection with real estate syndication, however, investors generally desire to plan their financial affairs based upon a reasonably specific term for each individual investment. Therefore, the partnership agreement should provide for termination at the end of a specific number of years with the additional provision that the assets of the partnership will be sold and the proceeds distributed to the partners in accordance with their interest at the expiration of the designated term or as soon thereafter as is practicable.

Centralized Management

The tax regulations provide that the corporate characteristic of centralized management exists if the general partner has the continuing and exclusive authority to make independent business decisions for the entire organization and if substantially all of the interests in the organization are owned by the limited partners. Section 10(a) of the Texas Uniform Limited Partnership Act provides that "a general

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13 TEX. REV. CIV. STAT. ANN. art. 6132a § 21 (1970).

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partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners." It further provides certain exceptions which do not relate to the day-to-day conduct of the business of the partnership. Section 8 of the Act provides that a "limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Thus, it is evident that the general partner has the exclusive and continuing authority to make independent business decisions for the the entire partnership; and, a limited partner will lose his immunity from liability if he takes part in the control of the business. Therefore, a limited partnership necessarily has the corporate characteristics of centralized management. However, Section 301.7701-2(c) of the Regulations provides that central management does not generally exist in a limited partnership formed under the Uniform Act unless substantially all of the interests in the partnership are owned by the limited partners. Thus, it appears that the corporate attribute can be negated by the general partner owning an interest in the partnership. A recent private ruling of the Internal Revenue Service in connection with the public sale of limited partnership interests aggregating $80,000,000 concluded that the partnership would not be taxed as a corporation wherein the original cash contribution of the general partner totaled $1,500,000. It is not entirely clear whether the particular element of central management was negated because of the ratio of the general partner's contribution to the limited partner's contribution. However, the ruling did specify that the tax treatment would be that of a partnership. An example in the Regulations hypothesizes that the general partners invested $300,000 and the limited partners invested $5,000,000. The corporate characteristic of centralized management was held to exist, "since substantially all of the interests in the organization are owned by the limited partners."[14]

Limited Liability

The limited liability with which we are concerned for a determination of whether the partnership is clothed with this corporate characteristic is that of the general partner rather than the limited partners. Pursuant to the provisions of Section 2 of the Act the limited partners as such are not bound by the obligations of the partnership unless they take part in the control of the business as specified in Section 8 of the

14 Int. Rev. Reg. 301.7701-3(b)(2) (1969).

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Act. The Internal Revenue Service in its recent private rulings sets out specific guidelines relating to the capitalization of a corporate general partner to satisfy the requirement that the general partner does in fact have liability in order to negate the corporate characteristics of limited liability.[15] More specifically, the position of the Service is based upon the premise that if the general partner has no substantial assets and is merely a dummy acting as agent for the limited partners, the general partner does not have personal liability. Therefore, it is imperative to conform to the following schedule in order to assure to the limited partners that the corporate characteristic of limited liability does not exist and the partnership will not be taxed as a corporation:

The corporate general partner must maintain at all times net worth equal to the following percentage of the contribution of the limited partners:

Limited Partner Contribution	Net Worth of General Partner
$1 to $1,666,667	15%
$1,666,668 to $2,500,000	$250,000
$2,500,000 and up	10%

For the purpose of satisfying this requirement each partnership for which the corporation serves as general partner will be computed separately. However, if the limited partners make additional contributions during the life of the partnership, all contributions must be taken into account for the purpose of determining the required capitalization of the corporate general partner.

Furthermore, contributions of all limited partners must be taken into account, including any contribution by the general partner as a limited partner. But the general partner's contribution as a limited partner is not included for the purpose of satisfying its net worth requirement for the partnership to which it contributes.

Transferability of Interest

The Internal Revenue Regulations permit a modified form of transferability without attributing this corporate characteristic to the partnership. Such limited transferability exists if each member is limited to a transfer of his interest to an outsider by first having to offer the interest

[15] Some private rulings require the capitalization requirement of the corporate general partner, as distinguished from an individual general partner, as an indispensable requirement for the partnership not to be taxed as a corporation notwithstanding the express language of Reg. § 301.7701-3(b) which requires the organization to resemble a corporation more than a partnership to be taxed as a corporation.

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to the other members at fair market value. If transferability is thus modified it will be given less significance as a corporate characteristic than full transferability. However, the regulations are not clear as to how much less significance shall be given.[16] It is clear that the transferability does exist when each limited partner has the power to substitute an outsider without the consent of the other members in a manner that will allow the transferee to acquire all the rights of the transferor. It is also clear that transferability, for the purpose of corporate distinction, does not exist if a limited partner can assign only his right to share in the profits and receive distributions but cannot assign his right to ownership.

A recent private revenue ruling furnished the basis for an $80,000,000 public offering whereby an individual limited partner divided his interest into a non-assessable and fully transferable interest. The ruling held that the partnership as such will not be subject to any federal income taxes and that the holder of a participation interest will be treated for tax purposes as though he were a limited partner to the extent of the proportionate interest that he acquires in the limited partnership interest. Although the fully transferable feature lends corporate attributes to the partnership, the lack of limited liability and a definite date of termination created the basis for the partnership to be free from federal income taxes. This form of doing business has revolutionary implications for real estate investments. It opens the door to public offerings of real estate investment interests which are free from the restrictions and complications imposed upon real estate investment trusts.

Consideration of Security Regulations

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . , transferable share, investment contract, . . . , or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[17]

Based upon this definition an interest in a limited partnership is a security. Therefore, in structuring an organization for a real estate

[16] Int. Rev. Reg. 301.7701-2(e) (1969).
[17] 15 U.S.C.A. § 77b(1) (1963).

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syndicate, the draftsman must consider the Securities Act of 1933,[18] the Securities and Exchange Act of 1934,[19] and the Securities Act of 1957.[20]

This article will not undertake to explore all aspects of the various securities regulations as they relate to real estate syndications. However, we should touch on a few of the basic considerations in order that the draftsmen may properly advise their clients. In order that the sale of limited partnership interests be exempt from registration under the Securities Act of 1933, one should comply with either or both of two available exemptions. The first such exemption in Section (a) (11) of the Act relating to intra-state offerings is discussed at length in the Securities Act Release No. 33-4434 wherein the commission states:

> A basic condition of the exemption is that the entire issue of securities be offered and sold exclusively to residents of the state in question. Consequently, an offer to a nonresident which is considered a part of the interstate issue will render the exemption unavailable to the entire offering. In view of the local character of the Section 3(a)(11) exemption, the requirement that the issuer be doing business in the state can only be satisfied by the performance of substantial operational activities in the state of incorporation. The doing business requirement is not met by . . . a real estate syndicate organized in one state to the residents of that state, in property acquired under a sale and leaseback arrangement with another corporation organized and engaged in business in another state.

The basic requirement of this exemption is that the entire issue "come to rest" in the hands of a bona fide resident of the state of issuer.

The other available exemption within the Securities Act of 1933 is the private offering exemption found in Section 4(2) of the Act. This exemption is discussed at length in Securities Act Release No. 4352 which explains that the availability of the exemption is simply a question of fact. This necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, and the nature, scope, size, type and manner of the offering. It is entirely clear that for this exemption, the Commission will take into account the number of offerees, irrespective of the number of actual purchasers. Most practitioners generally accept the maximum

[18] 15 U.S.C.A. § 77a (1963).
[19] 15 U.S.C.A. § 78a (1963).
[20] TEX. REV. CIV. STAT. ANN. art. 581-1 (1964).

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number of offerees to be twenty-five; however, the court of appeals in *Schimer v. Webster*[21] indicates that the twenty-five offeree rule has very limited significance.

Therefore, it appears incumbent upon the organizers of the real estate syndication to assure themselves that the investors are bona fide residents of the state in which the syndication is organized. The state selected should also be the state in which the property purchased by the syndication is located. The organizers should limit the offering to not more than twenty-five persons who are purchasers for investment purposes only, and who are knowledgeable in business matters and have the capacity to "fend for themselves." Care should be taken to avoid a series of syndications or offerings being treated as one by the Doctrine of Integration of Offerings. Release No. 4552 indicates that different offerings will be treated as one where they are a part of a single plan.

The basic exemption to be relied upon for the Texas Securities Act is found in Article 581-5(I). This section provides an exemption for the sale of any security by the issuer so long as the total number of securities holders does not exceed thirty-five persons and further provided that such sale is made without any public solicitation or advertisement. It should be noted that the state exemption differs from the federal exemption since the latter takes into account the number of offerees and the former takes into account the number of actual purchasers. By way of conclusion, the most advantageous exemption to utilize is the intra-state exemption for federal purposes and the thirty-five security holders for state purposes. However, to afford additional protection to the syndication it is advisable to limit the number of offerees to twenty-five. In this manner, the issuer has the benefit of two federal exemptions and consequently is well within the state exemption.

TAX CONSIDERATION IN DRAFTING LIMITED PARTNERSHIP AGREEMENT AND FILING PROCEDURE

The draftsman of the agreement who creates the limited partnership (Articles of Limited Partnership) must not only tailor its provisions to the business objectives of the partners and the legal relationship between them, but must also assure the limited liability of the limited partners afforded by a strict compliance with the Act,[22] and must further use particular care to assure that the various income tax considera-

[21] 225 A.2d 880 (D.C. Ct. App. 1967).
[22] TEX. REV. CIV. STAT. ANN. art. 6132a § 8 (1970).

tions do not defeat the partners' business objectives, particularly with respect to the favorable tax treatment afforded a partnership instead of a corporation.

To serve this purpose, the various aspects of taxation must be integrated with the provisions of the Uniform Act and the business purposes of the partnership in order to achieve the desired result.

Some thought should be given to the selection of the name to be used by the partnership in view of Section 6 of the Act imposing general partner liability upon a limited partner whose name appears in the partnership name. Of course, a name which is deceptively similar to the name of an established business should not be used and expose the partnership to possible litigation. Unlike the reservation of a name for a proposed corporation, the Secretary of State has no provision for reserving a name for a partnership and presently has no procedure to determine whether a certificate being filed conflicts with a previously existing partnership.

The partnership agreement must contain a statement indicating the nature of the business to be conducted thereby. In this connection, this author is of the opinion that the statement of purposes should be as broad as possible to avoid any risk that the doctrine of *expressio unius*[23] might result in the purposes being limited to those particularly specified. Any purposes which require some character of licensing under federal, state or local law must, of course, impose upon the partnership the obligation to secure such license prior to its commencing business.

The terms of the partnership must be included in the agreement. Attention should be given to a termination date that is consistent with the business purposes of the partnership and this must be handled in such a manner that the partnership will not be construed to have perpetual life for tax purposes.

The limited partnership agreement must specify each partner's pro rata contribution to the partnership. Similarly, this information is also required in the certificate filed with the Secretary of State.[24] Section 18 of the Act imposes personal liability upon a limited partner to the partnership for the difference between his contribution as actually made and that stated in the certificate. As a result, care should be taken that each limited partner makes his entire contribution as stated in

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[23] Carp v. Texas State Board of Examiners in Optometry, 401 S.W.2d 639 (Tex. Civ. App.—Dallas 1966), *rev'd on other grounds* 412 S.W.2d 307, *cert. denied,* 389 U.S. 52, 88 S. Ct. 241, 19 L. Ed.2d 51 (1967).

[24] TEX. REV. CIV. STAT. ANN. art. 6132a § 3 (1970).

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the agreement and certificate. If there is a desire to postpone a portion of this contribution to some predetermined time in the future or until the happening of some special event, such time or such event should be so stated in the agreement to avoid liability to the limited partner for such additional contribution if such time or event does not occur. The limited partner must contribute cash or other property because the Uniform Limited Partnership Act precludes any contribution of service by a limited partner.[25]

In the event that one or more of the partners is going to contribute property to the partnership, consideration should be given to the inclusion in the partnership agreement of a provision which utilizes the elections on contributed property offered by Section 704(c)(2) of the Internal Revenue Code. This Section permits a partnership agreement to provide that depreciation, depletion, or gain or loss shall be shared by the partners so as to reflect the difference between the basis of the property to the partnership and its fair market value at the time of the contribution.

Where one partner has contributed property with excess depreciation subject to recapture as ordinary income,[26] consideration should be given to the allocation of such gain between the partners on the subsequent disposition of the property. One suggested equitable basis of allocation might be that the contributing partner report that proportion of the gain realized as the potential gain existing at the time of contribution bears to the total gain realized.

When undivided interests in property are contributed by the partners, depreciation, depletion, or gain or loss with respect to undivided interests are computed as though the property was not a partnership asset, but as though the property was held directly by the partners.[27] This rule applies only if the relative interests of the partners in the property before contribution corresponds to their interest in the partnership after contribution and if the partnership agreement does not provide otherwise. It may be advisable to include in the partnership agreement a provision that such property shall constitute a partnership asset for the purpose of depreciation, depletion, and gain or loss, or recapture of excess depreciation under Section 1245 or Section 1250 of the Code.

If it be the intention of the partners to pay a salary to one or more

25 TEX. REV. CIV. STAT. ANN. art. 6132a § 5 (1970).
26 26 U.S.C.A. §§ 1245, 1250 (1967).
27 26 U.S.C.A. § 704(c)(3) (1967).

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of the partners for his services in managing the partnership, or, if interest is to be paid to one or more of the partners on his capital contribution, the amount should be specified in the agreement to assure the right to deduct such payment from partnership income.[28] The amount so provided must be reasonable. A deduction is allowed under Section 707(c) of the Internal Revenue Code for any fixed or guaranteed amounts paid to partners as salaries, or interest for the use of their capital. Guaranteed salaries and interest payments should also be specifically stated in the agreement. The maximum tax of fifty per cent on earned income effective in 1972 (sixty per cent in 1971) makes it important to distinguish between salary and other forms of compensation for personal services and interest. Where capital is a material factor, under the maximum tax on earned income[29] a reasonable salary but not more than thirty per cent of his share of the profits is earned income. Drawings from the partnership are distinguished from salary in that drawings are advances against the profits to be determined at the end of the accounting year and as such are not deductible by the partnership.

Management of the partnership is an important factor which should be detailed in the agreement. Normally, the general partner or partners will have the exclusive authority to manage the affairs of the partnership. To protect the status of a limited liability, the limited partner may not control or participate in managing the partnership. Therefore, thought should be given to permitting the general partner to employ persons or firms to aid the acquisition, management and disposition of the partnership property. The agreement should further contain an indemnification provision by the partnership from any claim or cause of action arising out of the general partner's management of the partnership affairs. The indemnification provision should include liability arising out of gross neglect, willful misconduct or breach of any specific provision of the agreement. The agreement should specifically prohibit acts by the general partner in accordance with Section 10(a), (1), (2), (3), (4) and (5) if for no other purpose than to call to the attention of all the partners that such statutory prohibitions are likewise prohibited by the agreement.[30]

If it is the intention of the partners that the partnership continue after the death of either a general partner or a limited partner, specific

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[28] 26 U.S.C.A. § 707(c) (1967).
[29] 26 U.S.C.A. § 1348 (Supp. 1971).
[30] TEX. REV. CIV. STAT. ANN. art. 6132a § 10 (1970).

provisions should be included in the agreement for a successor general partner, and if the partners so intend, a method for computing the payment to the estate or heirs of a deceased partner, as well as an obligation upon the estate of the deceased partner to sell for a predetermined consideration. The two principal ways of pay-out for retired or deceased partners are payments made by the partnership in liquidation of his interest[31] and purchased by the remaining partners.[32] If the transaction is in the form of a sale to the remaining partners and the partnership is not deemed to be controlled within the meaning of Section 707 of the Code, the seller will have an opportunity to get capital gains on the amount above his basis according to the usual rules.[33]

The 1954 Internal Revenue Code generally considers a partnership to be an entity in connection with transfers, but an aggregation of individual businessmen for other purposes. Section 736 of the Code directs that payments made in liquidation of a deceased or retiring partner's interest be allocated first to payment for his capital interest in the firm, as computed under Section 736(b) and payments in excess of that value be attributed to ordinary income items as computed under Section 736(a). Unless the partnership agreement provides to the contrary, capital payments will not include any sums paid for partnership good will, but would be ordinary income to the recipient. Payments under Section 736(a) result in an income deduction to the remaining partners, while those payments under 736(b) do not.

Liquidation of a partner's interest is defined as the termination of his entire interest by means of a distribution or series of distributions made to the partner by the partnership.[34] The treatment of such sum as capital gains or ordinary income is controlled by Section 736. If the partnership agreement provides for a sum certain, the amount allocated to capital interest is the fair market value of the interest in the partnership. If the agreement provides for payment by percentage of earnings over a period of time, the amount allocable to capital is determined in accordance with the Regulations. That portion of the buy-out allocated to income payments under Section 736(a) may either be paid out by stated percentage of future earnings (frequently the source of conflict with widows and survivors) or by specific fixed

31 26 U.S.C.A. §§ 736, 761(d) (1967).
32 26 U.S.C.A. §§ 741, 751(a), 1014(a) (1967).
33 26 U.S.C.A. §§ 741, 742 (1967).
34 26 U.S.C.A. § 761(d) (1967).

amount, or guaranteed payment; in any event the agreement should provide for the manner of the pay-out.

The individual partners must receive a partnership income tax return (Form 1065) from the partnership at the end of the calendar year in order to include their respective portion of the gains, or losses, of the partnership in their personal tax return. Under Section 704 a partner's distributive share of any particular item is determined in accordance with his distributive share of the partnership's taxable income or loss, unless the partnership agreement provides otherwise. The agreement may provide that different partnership items shall be shared by the partners in different proportions, as long as the allocation reflects the economic realities of the business arrangement between the partners.

Under Section 704(d) of the Internal Revenue Code, a partner may deduct his share of partnership losses only up to the amount of his basis for his partnership interest at the end of the partnership year in which the loss occurred. Any excess of loss over the amount of his basis may be deducted at the end of the partnership year, only if the excess is repaid. The agreement should specify the appropriate accounting period, preferably a calendar year, if the limited partners are individuals, and obligate the partnership to prepare and furnish the partnership return to all the partners.

The agreement should cover all matters concerning the winding up of the partnership. For tax purposes termination is determined without regard to state law. The partnership is deemed to be terminated when, within a twelve month period, fifty per cent or more of the total interest in partnership capital or profits is sold or exchanged.[35] Such termination closes the partnership's taxable year with the result that income from two years may be included in one year. To protect partners against such sale and resulting termination during the taxable year, it may be advisable to include a provision in the agreement requiring consent of partners to a transfer of partnership interest.[36] Unless the partnership agreement treats termination on account of death as a sale, the deceased partner's interest continues to the end of the partnership taxable year. This may be detrimental to the estate of the deceased partner since the share of partnership income includable in the decedent's last return might be offset by normally heavy deductions in the last year of life. A provision in the partnership agreement clos-

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[35] 26 U.S.C.A. § 708 (1967).
[36] *Id.*

ing the partnership accounting year upon the death of a partner will be ineffective for tax purposes to the remaining partners if they continue the business in partnership form.

A withdrawing partner's taxable year is determined by the extent that his interest is withdrawn. A change in membership through death, withdrawal, or addition of a partner does not ordinarily close the partnership's taxable year before its normal period of closing. If the entire interest of a partner is liquidated, sold or exchanged, the taxable year of the partnership closes with respect to that partner; but the partnership year with respect to the other partners is not affected. Upon closing of the partnership year with respect to a partner, the distributive share of income or loss of the partner is determined as of the date he ceased to be a partner in accordance with the agreement.

If only a portion of a partner's interest is sold or exchanged, the partnership year does not close with respect to that partner. His distributive share is determined at the close of the partnership taxable year. The general rule is that the partner's interest continues to the end of the partnership tax year and his final return will include only that income or loss for the partnership year that ends within his last tax year. The subsequent income is "in respect of a decedent." The above rules may be changed by the agreement to meet the expected needs of the partners. Consideration should be given to a provision prohibiting the limited partner from assigning any part of his interest in the limited partnership so as to prevent the IRS from attributing the characteristic of freely transferable interest to the partnership; therefore taxing the partnership as a corporation. The partnership agreement may provide that a limited partner shall have the right to assign all or any portion of his right to receive distributions from the partnership with the further provision that upon such assignment the general partner be notified.

Section 3 of the Texas Uniform Limited Partnership Act provides for the filing of a certificate in the office of the Secretary of State, (filing fee $25), in order to effectively create the limited partnership. It is advisable for the partnership agreement to contain a provision whereby the limited partners give the general partner an irrevocable power of attorney to file such certificate, together with any amendments thereto that may be required in the event a substituted or additional limited partner is to be included subsequent to the original organization of the partnership. There are other requirements of the Uniform Act which must be included in the certificate.[37]

[37] TEX. REV. CIV. STAT. ANN. art. 6132a (1970).

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Upon completion, execution and acknowledgment of the partnership agreement, a certificate should be prepared, executed and sworn to by each of the partners in accordance with Section 3 of the Act and forwarded to the Secretary of State, State of Texas, Austin, Texas 78711, along with a check in the amount of $25 to cover the filing fee. The transmittal to the Secretary of State should contain a request that the office advise the partnership, in writing, that the certificate has been filed in order to have written evidence that the statutory requirements have been satisfied. In the absence of such a request, the office of the Secretary of State will simply file the certificate and the partnership will have no method of demonstrating to the parties with whom it deals that the certificate has been filed.

The present trend of real estate investment is taking the form of utilizing the capital contribution of a number of persons rather than the former practice of an individual making such investments for his own account. As we are all aware, this syndication concept, usually in the form of a limited partnership, has been utilized in the oil and gas industry for many years. It is the opinion of the author that the limited partnership, either public or private, will be utilized increasingly as the number of requirements for judicious real estate investment continue to increase in geometric progression. Therefore, the State of Texas practitioner is well advised to become familiar with the various statutory and tax aspects of this form of doing business in order to more capably serve his client.

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